> INVESTMENT STRATEGY & ECONOMICS

MARKET WATCH

In brief – February edition

- With time, wealth grows for those who remain committed to their long-term strategies.
- Status quo for the A$ is expected to be down down.
- We would argue that the prospects for emerging markets are superior to those in developed markets.

The environment is beginning to normalise

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Over the past year advanced economies have provided investors with some reassuring signs of improvement. This has translated into strong performance in global share markets over the period.

This improvement has come as some relief for investors who have had the courage and patience to remain invested through what has felt like a long-bumpy journey. The end of 2013 marked the fifth anniversary of the nadir of the global financial crisis (GFC). The sense of loss at the time is still vivid in the minds of many investors.

While investor outcomes will differ depending on product choices and cash flows, in many cases, wealth has been rebuilt for those who stayed the course and remained invested.

As we enter 2014 we have been watching the trends of advanced economies which are showing promising signs of rebuilding since the lows of the GFC. In particular, the US economic recovery appears to have finally got a firmer footing, allowing the US Federal Reserve to start to reduce some of the stimulus measures it began implementing in November 2008. Importantly, the US housing market, the nexus of the financial crisis, continues to show signs of recovery, while at the same time investors have been cheered by good company earnings.

In Europe, the economic recovery has not been as smooth or as convincing. However, fears of a possible break-up of the Eurozone have receded and growth has returned if somewhat falteringly.

The Japanese government, under the leadership of Prime Minister Abe, remains firmly focused on implementing a variety of economic stimulus measures to lift its economy out of its long-term deflationary malaise.

In Australia, while the share market lagged its counterparts, the combination of gradually improving confidence, a pick-up in non-mining investment and stronger global activity are expected to support a growth rebound later in the year.

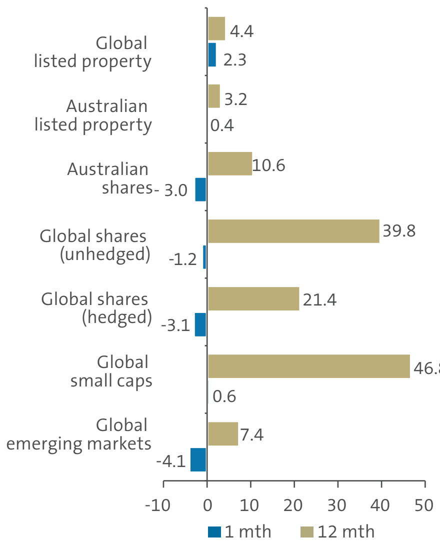
In summary, years of exceptionally accommodative monetary policy have ushered in a measure of confidence in the global economic outlook.

Bond prices, which have been unusually high, came under downward pressure as the economic environment began to normalise. Often when bonds sell off there's some concern that other assets could come under pressure. This wasn't the case last year. Shares in developed economies delivered strong returns off the back of an improved outlook for corporate earnings.

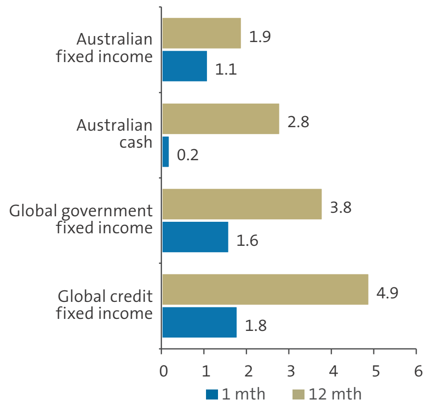
We expect to see a continuation of these trends with bond prices falling somewhat and share markets rising, albeit in a more muted fashion. Share returns are expected to be more closely aligned to earnings growth, which would be a good outcome.

While the current macroeconomic backdrop and its implications for investment outcomes are always essential components to investing, it's important to recognise that investors who remain committed to their long-term strategies can achieve sensible outcomes even in unusual environments.

Growth markets (%)



Debt markets (%)



Status quo for A$ is expected to be 'down down'

Last December the Australian dollar (A$) entered its fourth decade as a free-floating currency. Trading in the vicinity of US$ 0.90, it is almost exactly at the same level at which it first floated.

Over the A$'s free-floating history the currency has traded through a wide range and many of its shifts in value have been associated with periods of significant structural adjustment in the Australian economy.

Something old, something new

In the 1980s and 1900s the A$ fell as commodity prices softened on stronger supply. Investor sentiment favoured the US and Australia was seen as 'old economy', highly vulnerable to the ups and downs of world commodity prices. As a result, the A$ fell to US$0.48 in 2001.

The subsequent upswing of the A$ that lasted roughly a decade was underpinned by growth that emanated from large development efforts in the emerging world, largely driven by China. Australian commodities underpinned the construction of toll roads, infrastructure and bigger, taller cities. This demand, combined with a shortage in supply of key commodities provided a boost to Australia's terms of trade and with it a lift in the A$. When the US and Europe hit hard times, Australia was seen as being in a safe haven as its economy was in good shape on a relative basis. Given this, the A$ surged to a peak at US$1.10 in 2011.

Turning point

The A$ has declined nearly 20% from its 2011 high. Over the last year the A$ has fallen around 15% from US$01.05. This latest chapter in the history of the A$ has been driven by a combination of factors. There are lower commodity prices and increasing evidence that Australia is not as internationally competitive. In addition, there is a deterioration in Australia's relative growth outlook (e.g., US growth is lifting). Another relative factor is the lower official cash rate in Australia which has reduced the yield advantage over the US. The forces influencing the A$ in the period ahead point to a lower exchange rate.

Why does the exchange rate matter?

A lower exchange rate makes Australian's feel 'less wealthy' when traveling abroad. On the other hand, a falling exchange rate serves to boost the local value of overseas investments such as international shares. Finally, the combination of a lower exchange rate and a more aggressive approach by company management to boost productivity in the period ahead, is likely to result in improved corporate earnings over the medium term.

...the more they stay the same

A change of helm within the US Federal Reserve (Fed) isn't likely to lead to major change in policies that helped the US economy and financial system navigate through the stormy waters of its recovery.

Fed chairman Janet Yellen sought to allay fears that a pickup in US growth could be hurt by an unexpected shift in Fed policy at the semiannual monetary policy report to Congress. This was Yellen's first report as chair after succeeding Ben Bernanke.

At the same time an offer by the Republican party to help raise the US debt ceiling has also helped to lift investor sentiment.

Yellen suggested economic growth in the US would likely continue steadily in 2014 and inflation is expected to remain tame. She also noted the job market remained a worry and priority.

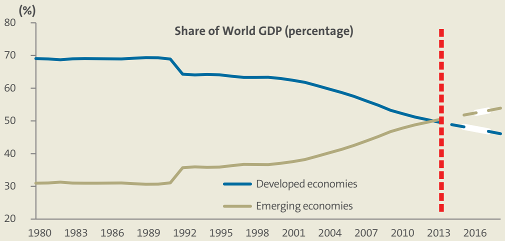
All this suggests the promise of policy continuity will likely continue in the period ahead as a recovery in the job market is an important factor in the Fed's stimulus decision making. The Fed's "forward guidance" is that it will not raise rates until the economy is strong enough to warrant it, based in measures of employment.

Yellen faces a challenge on how to eventually end easy monetary policies gracefully. Within the process, there may be periods where markets will be in for a bumpy ride. Nevertheless, a more prosperous US economy would be a strong source of global demand.

Trends of emerging markets

While in the past year emerging share markets have delivered a disappointing outcome as earnings were flat and valuations deteriorated, we would argue that the prospects for emerging markets are superior to those in developed markets. Reflecting the impact of good economic policy management over the past decade, the chart opposite highlights that the share of global activity sourced from emerging economies has risen significantly. This development is important for all investors as advanced and emerging economies are becoming increasingly integrated through the exchange of capital, goods and services which bodes well for corporates' prospects to access revenue growth.

When investing with a long-term goal it is crucial that developments are assessed in their proper context. While challenges do exist in many key emerging economies and it is not clear whether fundamentals will improve sufficiently for this advantage to be realised in the year ahead, the rapid development in emerging economies is forecast to carry on for a number of years.



Economic indicators

Gross domestic product (annual rate %)*	Latest	Current	Previous	1 year ago
World (IMF/OECD)	2012	3.3	n/a	3.9
Australia	Sep-13	2.3	2.4	3.2
China	Dec-13	7.7	7.8	7.9
European Union	Sep-13	-0.3	-0.6	-0.7
United States	Dec-13	2.7	2.0	2.0
Inflation (annual rate %)*	**Latest**	**Current**	**3 months ago**	**1 year ago**
Australia	Dec-13	2.7	2.2	2.2
China	Dec-13	2.5	3.1	2.5
European Union	Jan-14	0.7	0.9	2.0
United States	Dec-13	1.5	1.0	1.7
Official interest rates (%)*	**Latest**	**Current**	**3 months ago**	**1 year ago**
Australia	Jan-14	2.50	2.50	3.00
China	Jan-14	4.44	4.59	2.51
European Union	Jan-14	0.25	0.25	0.75
United States	Jan-14	0.25	0.25	0.25
Bond yields (%)	**Latest**	**Current**	**3 months ago**	**1 year ago**
Australia 3Y	Jan-14	2.84	3.00	2.82
Australia 10Y	Jan-14	4.00	4.02	3.45
United States 2Y	Jan-14	0.33	0.31	0.26
United States 10Y	Jan-14	2.64	2.55	1.98

Exchange rates

Official interest rates (%)+	Latest	Current	3 months ago	1 year ago
Australian Dollar / Chinese Renmimbi	Jan-14	5.2874	5.7715	6.4868
Australian Dollar / Euro	Jan-14	0.6470	0.6966	0.7685
Australian Dollar / Great British Pound	Jan-14	0.5309	0.5894	0.6579
Australian Dollar / Japanese Yen	Jan-14	88.9863	92.9102	95.1933
Australian Dollar / United States Dollar	Jan-14	0.8725	0.9470	1.0431

Share market analysis

Sharemarkets (in local currency)	5yrs (%pa)	3yrs (%pa)	1yr (%)	3 months (%)	1 month (%)
Australia : ASX 300 Accum	12.8	7.3	10.6	-3.5	-3.0
Germany : DAX	16.5	9.5	19.7	3.0	-2.6
global emerging markets : MSCI in AUD	9.4	3.6	3.7	-3.3	-3.5
Japan : Nikkei	7.7	1.0	7.4	-1.4	-4.1
United Kingdom : FTSE 100	13.3	13.3	33.9	4.1	-8.5
United States : S&P 500	16.6	11.5	19.0	1.5	-3.6

**Data is most current available
+Rates are expressed as 1 Australian Dollar
(IMF/OECD) purchasing-power-parady

Indices: Global shares: MSCI World ex AU Accumulation, Asian shares: MSCI AC Far East ex JP Accumulation, Emerging market shares: MSCI Emerging Markets Accumulation, Australian Shares: S&P ASX 200 Accumulation Index AUD, Global bonds: Barclays Global Aggregate Index Hedged AUD, Australian bonds: UBS Composite All Maturities Index AUD, G-REITs: UBS WARBURG Global Investors Index Accumulation Hedged AUD, A-REITs: S&P ASX 200 A-REIT Accumulation Index AUD, Direct Property: Mercer Unlisted Property Index, Cash: UBS 90 Day Bank Bill Index AUD.